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Exposure Draft ED/2013/3 Financial Instruments: Expected Credit Losses

Dear Sir/Madam,

Thank you for the opportunity to comment on your Exposure Draft ED/2013/3 Financial Instruments: Expected Credit Losses. The Volkswagen Group is one of the world's leading automobile manufacturers and the biggest carmaker in Europe. Our parent company, the VOLKSWAGEN AG is located in Wolfsburg, Germany. The group currently operates 100 production plants in Europe, the Americas, Asia and Africa. Around the world over 550,000 employees produce more than 37,000 vehicles or are involved in vehicle-related services each working day. The Volkswagen Group sells its vehicles in more than 153 countries. With our 100%-owned subsidiary Volkswagen Financial Services AG we are also the largest automobile financial services provider in Europe. As of December 31, 2012, our total balance sheet amounts to €309.644 million and our sales revenue amounts to €192.676. On behalf of Volkswagen AG, Wolfsburg, we are pleased to provide you with the requested remarks to the proposed Exposure Draft in response to your invitation to comment.

In general, the expected loss model leads to a better presentation of the credit risks of an entity compared to the incurred loss model. First and foremost the implementation of an expected loss model however must be practical. Finally there should be no lack between standard requirements and appropriate use of such a model.

Concerning the questions we present the following key statements:

- In terms of 12-month expected credit losses Basel II parameter should be generally allowed to be used for a financial services provider without any adaption.
- In addition, it should be generally allowed to use the 12-month PD as transfer criterion to determine a significant deterioration of the credit quality and thus to switch from stage 1 to stage 2.
- The proposed credit deterioration approach and the exception of low credit risk financial assets are to be supported. However the required application of a lifetime expected credit loss in case of significant credit deterioration will lead to overstated loss allowances. The standard should be more principle based to allow following internal risk management practices. For example, the reference to "investment grade" for low credit risks should be deleted.
- The transitional requirement in terms of a retrospective application should be drafted more flexible to avoid being forced to use life time PD's at the beginning which would distort the presentation of provisions in the following periods.
- The requirement to use a lifetime-PD for the entirety or parts of the living portfolio if an expected increase in defaults due to a deterioration of the economic conditions cannot be assigned to contracts is not appropriate (explanations can be found under Q5).
- The modification approach is quite complicate and will probably cause high implementation costs that will significantly outweigh the benefits. Thus, a simplification of this approach would be welcomed even if this approach is less precise.
- Whenever possible it should be generally allowed to use simplifications to avoid undue costs if these simplifications would probably have no material financial impact and would not challenge the main principles of the standard.
- The use of a decoupled approach is a good practical solution, but in our view one calculation method based on effective interest rate (original effective interest rate on gross carrying amount) is sufficient to avoid unnecessary complexity.
- We request the IASB to revise the overburdened disclosure requirements.
- The implementation and ongoing application of the expected credit loss approach is complex and associated with enormous costs, especially because of the necessary IT adjustments worldwide. Thus, a 3 years implementation period after the release of the standard is deemed necessary.

Below we address the issues which are of special relevance to us:

Q1: Objective of an expected credit loss impairment model

The proposed approach results in earlier recognition of impairment because an expected credit loss must be recognized from the time it is expected. Thus generally delayed recognition can be prevented. In sum, more useful information can be provided for the addressee.

In addition we advocate the proposed dual measurement approach, which will reflect in our view the economic link between the pricing of financial instruments and the credit quality at initial recognition and the effects of changes in the credit quality subsequent to initial recognition in a more appropriate way than the preferred single measurement approach of the FASB.

Furthermore we agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments.

Q2: Main proposals

Basically, we welcome both the proposed credit deterioration approach and the exception of low credit risk financial assets. However, the implementation of the proposal remains complicated and will entail huge efforts to implement due to the fact that the required data are based on single contract level. Thus, we would like to encourage the board to adapt the ED in order to simplify the ED wherever possible to avoid undue costs. This could contribute to more acceptance without challenging the main principles behind the proposal. In addition, the principle based approach should be more emphasized. Thus, examples should be deleted if they could lead to a restricted interpretation instead of avoiding misunderstanding of the principles behind the standard. Hence, it could be helpful to clarify that these examples shall not mean any restrictions or give ruled based guidance to the principles of the standard but should exclusively help to illustrate the main ideas of the principles. Otherwise, we would be concerned that examples could be misinterpreted as ruled based guidance.

We propose the following simplifications to contribute to a better balance between faithful representation of the underlying economics and the cost of implementation:

- Basel II parameters should be generally allowed without adaption, because these parameters are also integrated in internal risk management.
- Basel II 12-month PD should be generally used as a transfer criterion, because the 12-month PD is widely used in internal risk management to determine whether a significant deterioration of credit risks has occurred.
- The definition of low risk should follow internal risk management practices. We already differentiate between low risk and higher risks where intense care is required

in the non-impaired portfolio. Thus, we would prefer a flexible approach. Low risks are differently assessed from country to country and have to consider the local market characteristics.
- Examples should be reviewed if they are really necessary and contribute to advance the understanding (e.g. B15).

In addition, our understanding is that in terms of the definition of significance there is no link to other IFRS or IAS standards e.g. IAS 28. A clarification might be helpful to avoid misunderstanding.

In principle we agree with the rebuttable presumption that the criterion of a significant increasing of the credit risk is met when contractual payments are more than 30 days past due. In our view a clarification is necessary that only material amounts due and not insignificant amounts like overdue fees or outstanding interest payments lead to a reclassification in stage 2. Accordingly, we propose the following wording: „However, there is a rebuttable presumption that the criterion in paragraph 5 is met when a material part of contractual payments are more than 30 days past due." In addition, that would be beneficial because it would allow to use the past due counter according to Basel II which refers to a material part that is past due.

Q3: Scope

Yes, we agree.

Q4: 12-month expected credit losses

We cannot give a clear answer to this question. We think it should be differentiated between financial services providers and industrial companies.

We don't see problems for the financial services division as long as the Basel II parameter can be used. Thus, it should be generally allowed to estimate LGD's by discounting cash flows to the date of default and not to the reporting date. The reporting date is only feasible in case of determined cash flows. In case of stochastic cash flows that are uncertain and that have to be estimated by LGD parameters, it is only possible to discount to the date of default.

In contrast we think it will be a challenge to implement the 12-month expected credit losses for the automotive/industrial division. We are not quite sure about the way how to measure/estimate the possibility of default for each receivable, if general loss allowances on financial instruments are still not permitted under IFRS.

Q5: Assessing when an entity shall recognize lifetime expected credit losses

In general we appreciate the credit deterioration approach (see also Q2). We have the following proposals:

General use of 12-month PD as transfer criterion

Basel II 12-month PD should be generally used as a transfer criterion, because the 12-month PD is widely used in internal risk management to determine whether a significant deterioration of credit risks has occurred. Moreover, the criterion is much simpler and from a conceptual point not inferior to the lifetime PD, because maturity effects are not to be eliminated in order to make lifetime-PD's comparable based on the remaining lifetime of the contract. The 12-month PD has the advantage that a significant deterioration of the rating immediately signals a significant deterioration of the credit quality. In contrast to a 12-month PD as transfer criterion, using lifetime PD's is very complicated because you have to keep a history of PD's for the remaining lifetime at the beginning of the contract. For a contract with a term of 15 years e.g. it would mean to keep a history of 15 PD values with a remaining lifetime of 15 years beginning with a remaining lifetime-PD of 15 years, 14 years etc., down to 1 year to be able to compare the lifetime-PD's based on the remaining lifetime of the contract in the following years. Especially, for retrospective application, a lifetime PD as transfer criterions seems virtually impossible.

Definition of low risk should follow internal risk management practices

See answer to Q2. We would prefer a flexible approach. Low risks are differently assessed from country to country and have to consider the local market characteristics. An example that is only commensurate for the assessment of credit institutions, sovereigns and large corporate companies, but not for SME's or private customers should be deleted. Thus we, advocate to delete the reference to "investment grade".

Use of management adjustments to appropriately reflect increasing defaults that are not reflected by the PD procedure instead of using a lifetime PD

The requirement to use a lifetime-PD for the entirety or parts of the living portfolio if an expected increase in defaults due to a deterioration of the economic conditions cannot be assigned to contracts (IE 40, IE 41, IE 52) is not appropriate because this overstates the risks inappropriately and causes technical volatility of provisions, if this situation is only temporary. If a PD-procedure is to be revised in the next months and if it is to be expected that the revised PD's can be assigned to customers/contracts afterwards, then it should be allowed to reflect the increase in defaults by management adjustment to the best knowledge of the company. Hence, these examples should be deleted.

In general, even significant increase in defaults usually means that only a minor part of the portfolio in relation to the entire portfolio is concerned, for which provisions are added. The portion of the portfolio which might cause a significant deterioration of the credit quality that is not recognised by the PD procedure should be rather small. Thus, it seems not to be appropriate to use a lifetime PD for the entire living portfolio.

The views expressed in the examples IE 40, 41 und 52 would mean that technical volatility of provisions would occur. For example, for a PD procedure that is not appropriately calibrated any more this means that the increase in defaults is not sufficiently reflected in the PD and thus the increase in defaults cannot be assigned to the contracts, a lifetime PD would have to be used to calculate a lifetime expected loss until the PD procedure will have been revised again and will be able to assign the revised PD's to the contracts. This would entail additions to the provisions which would significantly overstate the actual risks of these contracts. After a revision, the PD-procedure is able to reflect the increase in defaults and to assign the revised PD to the contracts. Then, a lifetime PD would only have to be applied for those contracts where a significant deterioration has occurred. This in turn, would mean to release provisions. For example, if a credit institution performs a validation of a scoring procedure and observes within a back testing that the defaults have been higher than the PD's due to a deterioration of the economic conditions, it would have (according to the illustrative examples) to use a lifetime-PD at the end of the year for accounting purposes if e.g. 6 months are required to revise the PD procedure. Accordingly, additional provisions would have to be added resulting from the use of the lifetime-PD. After the revision of the procedure and the ability to assign the revised PD's to the contracts, e.g. 6 months later, most of the provisions would have to be released again. Thus, we request to delete these examples. Instead, we propose that additional provisions should be added to reflect the increase that is expected due to the revision of the procedure under the assumption that all contracts will have been re-evaluated. This would help to avoid technical oscillations in provisions that cannot be explained economically.

Further, we are concerned about undue pro-cyclical effects that are not economically driven if a lifetime PD would have to be used for the whole portfolio and the increase in defaults is only temporary. Then, an expected loss might never incur. In such a case, the additional provision to be built due to a change from a 12–month PD to a lifetime PD would have to be released again in a cyclical upturn without having consumed most of the provisions because the expectation is no longer valid. Moreover, defaults do not mean losses. In a cyclical upturn defaulted customers frequently recover.

Thus, the change from 12-month PD to lifetime PD should only be obligatory if it is not to be expected in the long run that the default rate will not be sufficiently reflected by the PD. Otherwise, such undue pro-cyclical effects could jeopardize the usefulness of the new approach.

Nevertheless we appreciate the simplified approach for lease and trade receivables and we agree with the proposal that the model allows the re-establishment.

Q6: Interest revenue

The requirement to calculate the interest income in three methods (original effective interest rate on gross carrying amount, original effective interest rate on net carrying amount and credit-adjusted effective interest rate on net carrying amount) combined with the requirement to switch in the method based on the stage to which the financial instruments belongs, causes unnecessary IT workload and costs that will also extremely outweigh the benefit for the users. In our opinion one calculation method based on the effective interest rate (the original effective interest rate on gross carrying amount) is sufficient. Therefore the symmetrical approach is correct in a methodically way, but in our view not necessary, if you use only one calculation method like described and preferred above.

We appreciate the decoupling of interest revenue and loss allowances. In the same way we prefer the decoupling approach for credit-impaired assets for reasons of harmonization and to reduce complexity.

Q7: Disclosure

No. Overall the volume of disclosures is too extensive, especially for big Groups like Volkswagen with several hundreds of single entities that are in the scope of consolidation according to IAS 27 / IFRS 10 and that have different IT systems in place.

In particular IFRS 9.35, where the reconciliation of the gross carrying amount and the associated loss allowance from opening to closing balance for each of the three stages plus the purchased or originated credit-impaired financial assets is required, would cause a lot of additional workload on company level as well as on Group level. In our mind the costs of evaluating the data extremely outweigh the benefit of the gathered information for the users. The current reconciliation in IFRS 7.16 for loss allowances would be sufficient in our mind to fulfill the information requirements. We therefore propose to delete IFRS 9.35 and to keep IFRS 7.16 in place.

In IFRS 9.39 (d) (ii) explicit discount rates are required. Due to strength of competition we do not intend to disclose calculation data in the notes and therefore recommend to delete this topic.

The required quantitative information in IFRS 9.38 (contract modifications) and IFRS 9.40 (collaterals and credit enhancements) both require enormous efforts for big Groups like Volkswagen, where the costs outweigh the benefits. In both topics qualitative information should be sufficient.

Q8: Application of the model to assets that have been modified but not derecognised

No. For big companies/groups with several thousands or millions of retail loans and/or leasing contracts it would be very ambitious to gather the information regarding contract modifications on Group level. Furthermore, this would cause enormous costs because of necessary IT adjustments.

Q9: Application of the model to loan commitments and financial guarantee contracts

In principle we agree. Nevertheless, it could cause enormous costs because of necessary IT adjustments. Other possible implementation problems cannot be assessed at this early stage.

Q10-11: Exceptions to the general model

We agree with the simplified approach for trade receivables and lease receivables. In addition we would welcome from the industry´s point of view to extend the option for using the simplified approach to all financial assets.

In principle we agree with the proposals for credit-impaired assets. As described in Q6 we prefer the decoupled approach for credit-impaired assets as well.

In addition amendments/clarifications are missing on how to proceed in cases of derecognition of modified assets. Is there any possibility to transfer these assets from stage 3 to stage 1 or 2?

Q12: Effective date and transition

At that point in time it is difficult to predict what lead time is necessary for us to implement the proposed requirements. Because of the expected complexity involved in implementing the requirements, we would appreciate a lead time of three years after finalization of IFRS 9. Due to that fact we consider the current effective date of January 1, 2015 is too ambitious.

Nevertheless we agree with the proposed relief from restating comparative information on transition.

Finally, the transitional requirement in terms of a retrospective application should be drafted more flexible to avoid being forced to use life time PD’s at the beginning which would distort the presentation of provisions in the following periods.

Q13: Effects analysis

We agree with the IASB´s assessment of the effects of the proposals.

Best Regards,

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